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# The Power of the Plan:
## *Effective Implementation in Acquisition Financing*

*As asset-based lenders increasingly seek financing opportunities — and competitive advantage — through distressed company acquisitions, turnaround plans will play a larger role. The plans will not only assist the lenders with their due diligence but also serve to reduce their risk of loss once the deal closes.*

By Baker A. Smith

As asset-based lenders experience continuing consolidation within their traditional business base, they are pursuing deal opportunities beyond the typical refinancings and restructurings. They have learned that, with the up-tick in venture capital activity, acquisitions by platform companies and equity sponsors provide many new financing opportunities, as well as leverage over their competition.

What's more, lenders are not merely waiting for equity sponsors and intermediaries to bring acquisition financings to them. They are identifying acquisition opportunities and bringing them to the equity sponsor. These deals, which meet sponsor acquisition criteria and come complete with partially accomplished lender due diligence, give the lenders an inside track on the financing.

### Where Are the Lenders Finding These Acquisition Opportunities?

A variety of players are typically involved with companies that are or will be for sale, including turnaround groups like my firm, Morris-Anderson & Associates. For example, we were called in to help stabilize a textile company with $200 million revenue. When the need for new capital necessitated sale of a division, several lenders took the lead in bringing equity sponsors to the table. One of these equity groups scored the acquisition with their lender sponsor winning the financing.

There are certain expectations equity sponsors have about a distressed purchase that prospective lenders should know. First of all, sponsors are attracted by the bargain price. The assets of an underperforming company typically sell at a discount, and occasionally, the existing lender provides incentives to move the loan. These financial incentives can give the company a running start on its turnaround plan.

Equity sponsors also envision a growth opportunity. Aware that a distressed company is typically under-capitalized and under-managed, the sponsor believes revenues may have been similarly under-realized. With an infusion of new cash and new leadership, the sponsor expects an increase in revenues.

Equity sponsors may also believe there are under-utilized or other valuable assets that can be liquidated to help fund the turnaround. Perhaps because of mismanagement or loan covenants under previous ownership, such sales opportunities may have gone unrealized.

Lastly, with the rare exception of the sponsor who is "on a mission," equity sponsors expect to make a profit on the acquisition. Assuming the company returns to profitability and profits grow over time, the equity sponsor hopes to eventually sell the company at a gain.

### What Are the Risks That Equity Expectations Will Not Be Met?

The greatest risk to both the equity sponsor and lender is most likely continued cash bleed. If negative cash flows are more prolonged or severe than budgeted, the company may run out of cash and borrowing availability before the turnaround plan gains traction.

Time is a stealthy risk. When events do not happen according to plan or timetable, lenders and sponsors question whether the company is running behind schedule or is totally off the tracks. For example, when a $300 million window-covering rollup faltered shortly after closing, my firm was called in to assess the situation. While top management felt the company was simply three months behind the plan forecast in financial projections, key managers were totally unaware there was a plan!

**Pro forma financials may not accurately or completely reflect the picture of the spin-off company when it becomes stand-alone.**

As one may guess, we found that implementation of the turnaround plan was not occurring and that operations were actually out of control.

Management represents another risk — whether existing management is retained or a new team is installed — as it may not deliver the results called for in the turnaround plan. Equity investors must have the expertise to know whether to accept management's explanation for nonperformance or conclude management is incapable. There are many reasons that key elements of the plan are not executed either in a timely manner or at all; yet these key events are essential to change and growth. Without these events, the equity investor many be left with the status quo, although far short of company and portfolio goals. Of course, a manager who ignores a milestone, in particular the CEO or CFO, can negatively impact the overall achievement of the turnaround plan.

No or slow plan execution is a stealthy but deadly risk. Delayed execution carries a high cost in additional cash outlays, missed revenue opportunities, lower profit performance and, eventually, lower portfolio gains once the portfolio manager decides to sell the company.

Unanticipated events also comprise an element of risk. It seems inevitable that surprises will occur. While it is always wise to budget a cash cushion for such events, the critical factor may be whether the company has the management and capital resources to navigate the troubled waters.

## What to Look for in the Turnaround Plan

The company's turnaround plan can and should address the forgoing risks and increase the company's prospects for success. First of all, the turnaround plan spells out the equity group's expectations for the distressed acquisition and explains how to achieve those expectations.

The plan also coordinates goals and tactics. As a written resource, the plan provides a uniform guide to several distinct stakeholders, including ownership, management, employees and lenders. The waters seem much easier to navigate when each and every stakeholder sails as a coordinated crewmember. On the other hand, much of my firm's business involves companies where stakeholders aren't working together, because the plan that exists in everyone's heads is different.

Another advantage of a turnaround plan is that it empowers management, equity and lenders to monitor specific milestones and results. By serving as a ready reference, not just of sales and profits, but also of various key events, the plan can help stakeholders obtain a quick and comprehensive status report.

Because of the foregoing advantages, the turnaround plan is also useful for attracting debt and equity. One of the most important resources for lenders and equity sponsors is information. If all other factors are equal, an investment and lending opportunity with a low-key, business-like turnaround plan will trump an opportunity surrounded by hubris. Why? A company with direction and the means to get there will likely be more successful than a company with greater enthusiasm but with less focus.

## Beware of the False Turnaround Plan

Both lenders and equity sponsors have learned through experience that a set of financial projections is not a true plan. At best, it is just a budget. While a budget is important to attract the support of investors and lenders, a budget is very difficult to achieve without detailed written assumptions and plan steps.

A true plan generally covers at least five functional areas: management staffing and organization, financial systems and controls, marketing, operations and deployment of assets. Specific actions must be taken within these functional areas to effectuate the numbers shown in the financial projections and budget.

A true turnaround plan is specific and assigns responsibilities to specific managers. Further, it clearly delineates timetables and milestones. It has specificity with respect to managers brings accountability and responsibility while avoiding blame-shifting and finger-pointing. Clear milestones and timetables facilitate monitoring and intervention as needed when goals are not met in a timely manner.

A true turnaround plan often provides incentives to management and the sales force for accomplishing its stated goals. Properly designed incentives keep managers working toward the same goals the equity sponsor has, and get a better bang for the buck when they pay for goal achievement, not serendipitous events. For example, my firm was asked to review a $100 million revenue aluminum distributor suffering from declining sales and profits. We found that some of the worst salesmen were the most highly compensated because of variance in revenue and gross margin formulas. Although ownership was very apprehensive about change, we overhauled the incentive system, which resulted in an immediate increase in both sales and profitability.

## Watching for the Pitfalls

Even with a valid turnaround plan, there are many implementation pitfalls to be alert to when financing acquisitions of a distressed business. Cash requires the most vigilance. Because many distressed acquisitions involve the takeover of a stream of losses, it is vital to determine whether the losses have been curtailed or are continuing. If losses continue beyond the point projected in the turnaround plan, there is a danger of running short on cash.

Customer erosion is another potential pitfall. Despite their warm assurances to the company, customers of distressed suppliers tend to hedge their bets, finding a secondary supplier and cutting revenues to the borrower. Worse, customers may make another company their primary supplier if they perceive the new supplier company to be more financially viable. Both scenarios may put pressure on gross margins as well as revenues, as competitors may lower their prices to lure customers away.

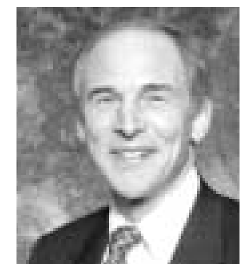
Yet another pitfall is tightening supplier terms. While suppliers may wax enthusiastic about new equity strengthening the company, they are sometimes reluctant to improve the company's terms. Terms that are less generous than projected will negatively impact the company's availability and cash flow. Because a distressed company is often on COD (cash on delivery) or CIA (cash in advance) terms, suppliers may resist shifting to, for example, 30- or 60-day payment terms because the pre-existing cash payments from the distressed company are more lucrative than for all other customers, including healthy companies.

However, even if a supplier does grant 30- or 60-day terms, the impact on the company can be closer to COD terms if suppliers set overall credit limits too low.

And spin-offs of divisions or product lines from larger companies present their own set of pitfalls. Pro forma financials may not accurately or completely reflect the picture of the spin-off company when it becomes stand-alone. For example, MIS (computerized Management Information Systems) and underlying operations-control methodologies may need to be created from scratch. Cash or material support that was available from the former parent may not have been factored into projections and plans. Critical supplier relationships may not transfer from the former parent to the spin-off as was assumed. Key customer contracts may survive, but may change in unforeseen ways, as new corporate structure and methods change customer perceptions. And essential marketing dynamics may not be replicated.

For instance, my firm was called in to help an equipment maker that was spun-off from a Fortune 1000 equipment manufacturer. The dealer network our client assumed they were distributing to shrank to less than 25 percent of the dealers who originally carried and sold the product. Among these remaining dealers, sales had fallen by more than 50 percent, thanks to the loss of the parent company's floor-plan financing upon execution of the spin-off.

As asset-based lenders increasingly seek financing opportunities — and competitive advantage — through distressed company acquisitions, turnaround plans will play a larger role. The plans will not only assist the lenders with their due diligence but also serve to reduce their risk of loss once the deal closes. When problems inevitably occur, mandated trigger points will facilitate the prompt and effective deployment of turnaround professionals, thus avoiding loan run-off and portfolio losses. abfj



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